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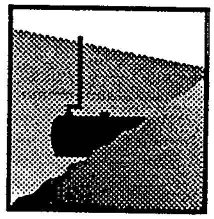
# PREVENTING LEAKING UNDERGROUND STORAGE TANKS



***Using Government Assistance Programs to Finance Tank System Improvements***

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# Executive Summary

Without some form of assistance, many small underground storage tank (UST) owner/operators--typically "mom and pop" gasoline service stations--will not meet new federal tank standards and will have to close. The new standards will force many businesses to upgrade existing tanks or install entirely new tank systems (tanks and associated piping). Undertaking such improvements requires capital. Because of their size, lack of sales volume, and limited collateral, however, small businesses often are rejected for loans, or the terms and conditions are so restrictive as to discourage them from accepting conventional financing.

The potential for loss of many small service stations has caused concern among federal, state, and local leaders. Loss of a business can hurt a community, especially a rural community with only one source of gasoline and heating fuel. Loss of jobs and tax revenue would bring more problems to economically distressed areas. Furthermore, leaks from abandoned underground tanks may go undetected and uncontained for long periods of time, thus contaminating the groundwater.

Governments at all levels can find creative ways to help small businesses overcome these problems. Setting up finance programs to ease the cost or terms of borrowing, augment private funds, or fill funding gaps that the private sector will not bridge are among the best options. For decades, federal, state, and local governments have used or sponsored public finance mechanisms to stimulate economic activity in certain geographic areas or industries. Some can be adapted and targeted to UST owner/operators. Already a few states have started such financial assistance programs.

All state and federal economic development tools fall into two broad categories: financial and nonfinancial assistance. Finance incentives are the focus of this report. (Nonfinancial assistance includes training and technical assistance such as management counseling and marketing advice.) Six types of financial incentives are particularly relevant for adaptation to UST needs: grants, loans, loan guarantees, interest subsidies, business development corporations, and tax abatements. Other finance programs such as bond programs, equity financing, tax credits and deductions, tax increment financing, and tax-free zones, have less general applicability, although they could prove quite suitable given the right circumstances.

These financial incentives can be used individually or combined to address a full range of needs. For example, grants can be combined with loan guarantees to target businesses not reached by the loan program. In designing an UST finance program, whether using one tool or a blend of tools, public officials should consider a number of factors. Six that are most crucial to success, are:

- setting terms of assistance to address the most important needs and correct for market shortcomings;
- targeting the program to businesses that really need it to improve and modernize without giving unnecessary subsidies to those capable of making investments on their own;
- determining the amount of funding needed and the timeframe in which those resources must be made available;
- minimizing the cost and complexity of administering and participating in a program;
- finding the optimal level of participation by private lending institutions; and
- determining the appropriate measure of program success to help policy-makers and administrators make informed decisions about needed modifications or changes in level and type of support.

This report is intended for states considering the establishment of an UST financial assistance program. Its purpose is to foster a better understanding among public officials of the various financing tools available and how such tools could be put to use in helping UST owner/operators. Most states have had similar economic development programs for years, but have only recently considered adapting them to meet environmental concerns.

This report is organized into three sections. The introduction provides background information on the problem faced by small businesses in complying with federal tank requirements. The first part discusses the key factors that public officials must consider when formulating an UST assistance program. The second part describes the kinds of public finance programs that could support UST improvements. The appendix describes the UST assistance programs of two states, Iowa and Ohio.

# Introduction

EPA encouraged the Institute to prepare this report as part of the agency's continuing effort to provide information and assistance to state underground storage tank programs. The agency is concerned about the ability of small businesses to comply with federal requirements and the potential impact of business closings on communities and the environment. The objective of this report is to foster a better understanding among public officials of the various financing tools that could be used to encourage small businesses to improve tanks.

## The Problem

As deadlines near for improving underground storage tank (UST) systems, many small tank owners/operators assert that they cannot afford to meet the new requirements. Upgrading tank systems (tanks, pipes, and leak detection) requires capital; however, conventional sources of capital often are out of reach for small, disadvantaged, and "high-risk" businesses. Bankers are skittish about environmental concerns. Even assuming that a commercial bank or other financial institution is comfortable with the environmental situation and possible liability that a prospective borrower shoulders--which they usually are not--the well-known risks associated with small business lending keep many smaller enterprises from securing the capital they need. Because of their size, lack of sales volume, and limited collateral, small business loan applications often are rejected, or the terms and conditions placed on them are so restrictive as to effectively discourage small businesses from accepting conventional financing.

Problems encountered by small businesses in obtaining the capital needed for improvements has caused many local leaders to fear that many businesses will simply close. The Petroleum Marketers Association of America estimates that approximately 26,500 stations are likely to close as a result of regulations. It projects that 61 percent of these stations are in communities of fewer than 10,000 people. Loss of a business can have a serious adverse effect on a community, especially a rural community that may have only one source of gasoline and heating fuel. Economically distressed areas will suffer further the loss of jobs and tax revenue. Finally, because the closed property probably will be untended, leaks may go undetected and uncontained for long periods of time, thus contaminating the groundwater.

To overcome such problems, the public sector can initiate a variety of finance programs to ease the cost or terms of borrowing, augment private capital resources, or fill funding gaps that the private sector will not bridge. This country has a long history of public-sector support for economic development activities. In recent years, governors and mayors have given top priority to retaining and helping businesses; many are doing so in a more creative, sophisticated, and comprehensive way than in the past.

Public-sector initiatives no longer rely solely on administrators with grantsmanship skills pushing a few applications. Now, governments take a more activist role: many have adopted an entrepreneurial stance, identifying and packaging public and private resources to put the economic development puzzle together. Increasingly, the solution requires a broad-based commitment from diverse players in several sectors--businesses and financiers, public and private economic development and training agencies, and resource institutions such as colleges and professional associations. It reaches into new sectors, like secondary schools and utilities, and incorporates new concerns like historic preservation and environmental well-being.

Spurred by concerns that small gas stations may close or that old tanks threaten the state's groundwater, a few states have started financial assistance programs to encourage UST owner/operators to improve their tank systems. The types and scope of these programs vary considerably based on each state's needs and goals. For example, Iowa's program supports rural businesses and is part of a broad state policy to preserve farming communities. In contrast, programs in Rhode Island and New Jersey seek comprehensive cleanup of leaking tanks. Encouraging rapid improvements in tank and leak-detection equipment are crucial to the ultimate goal of protecting human health and the environment.

The information that follows is intended for states that are contemplating an UST financial assistance program. Its purpose is to foster a better understanding among public officials of the various financing tools available and how such tools could be put to use in helping UST owner/operators. Many of these tools have been in place for years to spark state and local economic development activities, but they have never been adapted to meet environmental concerns.

The first section of this report discusses the key factors that public officials must consider when formulating an UST assistance program. The second section describes the kinds of public finance programs that could support UST improvements. The appendix describes the UST assistance programs of two states: Iowa and Ohio.

# 1. Key Factors to Consider in Formulating UST Assistance Program

Public officials contemplating an UST assistance initiative should consider a number of factors. This section discusses six that are most critical in planning a program, before final enactment: setting terms of assistance; reaching targeted customers; determining funding needs; minimizing administrative burdens; using private lending institutions; and measuring success.

## A. Setting Terms of Assistance

The needs of the state and the goals or intended outcome for the program will drive decisions on the terms of assistance. Put differently, officials must ask themselves what is the problem and what do we want to achieve? Rather than superseding the important role of key private-sector players, officials need to identify and assess market shortcomings and tailor a course of action to intervene, filling gaps or correcting weaknesses.

In determining the appropriate terms of assistance, officials need to decide the types and amounts of costs to be covered. Help could be provided for:

- some or all of the costs of tank system upgrades;
- some or all of the costs of improved leak detection;
- some or all of the costs of replacing tanks with new, protected tank systems;
- some or all of the costs of cleanups not covered by insurance; or
- some combination, or all of the above.

With a limited pool of funds, an agency could reach more businesses by restricting the amount of coverage--for example by covering only the cost of tank upgrades. On the other hand, it could provide greater public benefit by supporting fewer businesses but ensuring thorough cleanup and state-of-the-art protection. The decision depends on the amount of money available and the magnitude of the problem. In some cases, financial matching requirements could be used to stretch limited resources further.

Also important is the type and location of business and the type of aid needed by that business. Programs could be planned to support only small or disadvantaged businesses that otherwise could not afford to comply, or to support those in rural areas that serve as the sole source of gasoline or heating fuel for a community. If the primary goal of the program is to cleanup existing leaks, the most appropriate customer may be owner/operators of tanks known or suspected of leaking, or those located near drinking water wells.

In setting the terms of assistance, the governing agency must give due regard to the needs of the targeted customer. Both the timing and type of assistance provided is important. In a one-time improvement (either a cleanup or new or upgraded tank), the recipient's chief need is easily determined. For example, the recipient may have no access to capital at all, a situation which public programs can help rectify. This situation often occurs when the operator is a small business or one in a distressed community or inner-city neighborhood. In other cases, an operator may be faced with financing terms too steep to meet. Public agencies then can help reduce the costs of the initial capital by offering incentives to commercial lenders or by providing the capital themselves. In yet other situations, periodic offsets to ongoing capital demands, such as reducing taxes due, may be enough to ensure that needed investments are made.

In sum, officials must understand the obstacles to investment and attempt to overcome them. Many tools are available for public agencies to resolve economic development problems; eleven are described in the second section of this report. Some version of these tools can be used--separately or in combination--to meet several objectives, including:

- reducing the lender's risk by providing incentives for lenders to help seemingly risky businesses;
- reducing the borrower's cost of financing, for example, making capital more affordable by subsidizing or eliminating the interest charged on certain loans or allowing tax write-offs of interest payments;
- easing the borrower's repayment situation by providing flexible payment terms such as allowing the borrower to make payments over a longer time, or allowing an initial grace period;
- improving business cash flow by reducing or forestalling taxes; and
- providing start-up capital in exchange for partial ownership in the project.

## B. Reaching Targeted Customers

One of the most difficult and controversial issues facing officials as they devise financial aid programs to meet UST-related capital needs is defining who is eligible. Officials must determine a viable threshold of need; the program must offer sufficient help to businesses that really need it to improve and modernize without giving unnecessary subsidizes to companies capable of making investments on their own.

Economic development officials use targeting techniques to decide who benefits from the program incentives and to address the special needs of people, places, or firms. Targeting strategies are diverse but all have a common thread--to channel investment activity to, and derive benefits for locations, sectors, or groups that are at some perceived disadvantage in the private marketplace.

The advantage of targeting is that it channels activity to make maximum use of limited resources. The disadvantage is that it can be difficult to define the primary target; thus needy people, places, and firms on the margin may be excluded from the program in a seemingly arbitrary manner. For example, Ohio's special loan program limits those eligible to tank owners with six or less tanks. This cut-off was based on a determination that most of the intended targets, primarily small single-outlet marketers, would fall within that definition. An owner of seven tanks, however, could well be a small, struggling operation unable to afford compliance, but is excluded from the program. As a result, the loan program puts this business at a severe competitive disadvantage.

The appropriate definition or threshold will vary significantly among states and regions. For example, while Ohio defines a small business as one owning six or less tanks, Iowa's cut-off is 12 tanks or less. Before defining the targets, state agencies must have information on the businesses to be targeted and their needs. Many states have undertaken surveys to determine the number, size, location, ownership, and type of business of tank owner/operators. Public officials also need to know how many businesses need or would be eligible for help to determine how the program should be structured.

Program resources can be targeted several ways: tailoring incentives to be useful only to intended targets; directly through eligibility requirements; indirect targeting; and discretionary targeting.

### Tailored Incentives

The most direct way to target incentives is through statutes and regulations that make the incentive useful only to specific types of firms, like station operators, or for specific activities, like replacing tanks. Guidelines could be written, for example, to cover only the costs for cleanup of a leaking tank or tanks at least 20 years old. It is important that appropriate incentives be linked to the targeted beneficiaries. For example, tax credits may stimulate little activity for a cash-strapped operator; interest subsidies, on the other hand, can make a project economically viable.

### Eligibility Requirements

Program use can be limited by establishing eligibility requirements in the enabling statute or regulation. Such requirements could be geared to certain business characteristics such as size, type, or ownership. For example, a few states provide assistance for small owner/operators by defining eligible businesses as those that own less than a specified number of tanks, or ones that sell less than some designated amount of gasoline per month. The definition of a small tank owner/operator will vary among regions and states.

Other criteria of this type could be linked to the site and might include age of tanks. Eligibility criteria could also be geared to the broader economic context of the business operation. For example, assistance could be tied to the projected economic impact on the local area such as tax revenues lost due to closure or jobs retained because the business is able to continue operating.

Eligibility can also be defined by purely geographic factors. For example, assistance could be restricted to businesses in specially designated distressed areas, towns with less than some specified population, counties with less than a minimum number of service providers, or areas of unique environmental conditions, such as groundwater vulnerability, percentage of population relying on groundwater for drinking water, and so forth.

Targeting through eligibility requirements allows very little flexibility, which may be a problem for certain businesses that do not meet the criteria exactly. This type of targeting, however, is advantageous if the government plans to rely on private institutions to administer the program (this is discussed more fully later in this section).

### Indirect Targeting

Sometimes, indirect targeting is politically advantageous. This strategy involves laying out a broad-based program but structuring the assistance to be useful only to certain types of firms, or defining program criteria in such a way that effectively limits its use to certain firms. This can be done in numerous ways. For example, an UST program could be indirectly restricted to smaller companies by setting a relatively low cap on the amount of loan proceeds that can be guaranteed or funding improvements for six tanks per business only.

Program resources also could be targeted indirectly to small users posing the greatest environmental threat by linking the program to certain levels of contamination while limiting outlays per business. This can be done, for example, by providing money only for replacing known or suspected leaking tanks, but then limiting the assistance to six tanks per business. This would narrowly focus the program on small operators with big problems--and also those most likely in need of help--without specifically eliminating from contention a range of operators whose political support may be needed to pass a program.

### Discretionary Targeting

An alternative to targeting with strict eligibility criteria is to permit the administering agency to exercise discretion in approving program applicants that meet broad eligibility criteria. This is essentially targeting on a case-by-case basis and is often used when important criteria are not easily defined or quantified, such as in venture capital programs where the chief factor is the potential for success. Similar approaches could be used for UST assistance based on level of need or extent of threat to public health and the environment. This type of discretionary approach, however, must be carefully sheltered from political pressures if it is to succeed.

In the case of UST, several types of targeting could occur depending on priorities and amount of funding available. Small, independent operators could be the primary targets specified in the eligibility criteria. The administrative agency could then have discretion in selecting priorities among the small businesses based on level of risk (tank age, proximity to drinking water wells), location, or other appropriate factor.

## C. Determining Funding Needs

As previously mentioned, the types of costs covered, the number of targeted users and the amount necessary to meet their needs are important factors in determining how much money must be allocated to an UST assistance program. Also important, however, is the type and terms of financial assistance offered. The actual cash needs for any program vary, and are determined by several design elements. For example, a direct loan program has very different funding needs and outlay timetable than a loan-guarantee program or interest-subsidy incentive.

Financing programs can be grouped in several ways, according to the level of resources needed for the program to operate, and the timeframe in which those resources must be made available.

**Continuous Funding Needs**

Public officials and business persons who have little contact with financial-assistance programs commonly perceive that they require a regular source of revenue to continue and must be fully funded at the outset of each funding cycle. In reality, however, only a few programs require this kind of funding. Grants are the most common, but also the most costly per project because there is no direct return on the money and the grant generally covers most, and in some cases all, of the costs of the project. In addition to grants, programs offering subsidies to reduce the interest charged on loans issued by private lenders also must be replenished if they are to continue as there is no payback. However, these programs require less funding per project than grants.

A variation of continuous-funding needs are programs that result in foregone tax revenues rather than requiring a specific annual appropriation. Such tax-abatement programs reduce or eliminate tax payments due on specific property, often for five years or more. Although these programs do not need to be funded directly, the net effect is that total tax revenues are reduced. In some ways, tax abatements are like back-door grants.

The major disadvantage of continuous-funding programs--in an era of increasing demand but fewer public-development resources--is that they are very costly on a per-project basis. Such programs allow no direct recovery of the state's investment, although the funds may be returned in other forms such as increased tax revenue from profitable businesses or retained jobs. Also, until a program is firmly entrenched, it is subject to the whims of the appropriations process each year.

On the other hand, because the government is, in essence, funding significant portions of the project, it can exercise considerable control over how the funds are to be used and who is to benefit. Program goals can be defined more narrowly and refined as circumstances change, and--in theory--resources can be targeted most effectively. Such programs allow the government to address the most pressing problems without having to attract and keep third-party participation. Finally, a well-structured grant or tax-abatement program generally will incur fewer administrative costs than other types of assistance programs and issues of default and cost-recovery--so vital to direct loan and loan guarantee programs--are largely moot.

### One-Time Infusion of Funds

Across the country, hundreds of development-finance programs have been launched with a one-time infusion of public money. Although their objectives and constituencies vary, virtually all are set up as direct loan programs or revolving loan funds. Loan funds may be designed so that--if properly managed--they can become self-sustaining and do not need additional public resources. In this case, the fund pool is replenished by loan repayments and interest income so that new loans can be made. In many instances, the interest paid on the loan is earmarked for administrative costs.

The amount of money needed initially depends on several factors: amount of assistance offered to each participant, number of potential participants, and expected payback and default rates. The primary advantage of this type of financing mechanism is that public funding can serve as a catalyst, rather than becoming an ongoing need. Political leaders may be more willing to risk funds on a one-time basis, especially for a new initiative. If it fails, losses are minimized. Also, the one-time infusion can be a good way to test a particular approach to addressing the problems of UST owners--a small amount of money can be devoted to the program initially and increased with subsequent appropriations if the program proves successful. Often, as programs show signs of success, demand will increase and states will supplement the original fund with additional capital. This allows the program to make more loans more quickly than repayments of the original fund would allow.

### Reserve Fund

A third category of financial programs requires establishing some type of reserve fund at the outset that is not regularly tapped. Usually, this "reserve fund" is a fraction of the total level of program activity. The federal Small Business Administration program, for example, set aside a reserve fund of only $107 million in fiscal 1989 to support the nearly $3 billion in new loan guarantees for that year.

Such reserves typically are set up for loan-guarantee programs in which the government guarantees to pay off a sizeable (usually 75 to 90 percent) portion of a loan made by a private lender in the event the borrower defaults. Reserves are drawn upon only when a firm defaults. If default rates are low, loan-guarantee programs will cost little over time. However, with each default, the cost of a guarantee program increases.

Initiatives based on reserve funds have the advantage of encouraging considerable investment without large public outlays. In fact, a program that closely scrutinizes the loans it is asked to guarantee may have virtually no defaults, making its actual cost to the public sector very low. On the other hand, a low default rate may mean that the eligibility requirements are so stringent that the truly needy tank owner/operators are excluded because they cannot meet creditworthiness standards. Generally, loan-guarantee programs are best targeted to businesses on the margin of risk, rather than those that carry big risks.

Other programs that help with or promote financing require little in the way of cash from the state to operate; their benefits come in other ways. Instead, the government might participate in a linked deposit program by placing state funds in private banks to encourage them to lend in targeted areas. Such programs carry no risk; the only cost is that the government may accept a lower return on its deposit in exchange for the lender's participation. These and other tools are described in detail in the second part of the report.

## D. Minimizing Administrative Burdens

The cost and complexity of administering an assistance program is often overlooked by legislators in their push to develop a program that addresses constituents needs. While it should not be the only factor considered, relative ease of administration can have a significant impact on the overall success of the program. Complex programs usually require more money to administer, leaving less for project assistance.

Programs must be flexible and easy to use, allowing variable approaches to reach a common objective. A web of local, state, and federal programs, policies, and regulations has grown that too often stifles rather than helps states and municipalities make the best use of available resources. As a result, opportunities are missed and jurisdictions are prevented from making the most logical and cost-effective use of their own resources to advance their interests. An overly complex program may intimidate potential customers, especially if the targets are small or rural businesses with little experience with public finance programs.

In planning a program, public officials must consider which agency or organization will have primary responsibility for administering the program. Officials must consider expertise required, most appropriate organizational structure, and the agency's or organization's relationship with potential customers. Many types of organizations can be used with equal success.

**State Economic or Community Development Departments**

Every state development department or agency administers some type of financial-assistance program--sometimes dozens of them. They are, therefore, veterans at implementing and monitoring public and public-private financing initiatives. Many are ably staffed with experienced business development and credit analysts. Because of constitutional or statutory restrictions, however, some agencies may be limited in their experience in structuring targeted or creative finance programs tailored to certain constituencies or needs. In addition, because state development agencies are so visible, with the governor held accountable--justifiably or not--for their record of success, they are often reluctant to take on unusual projects or deals with a perceived high risk.

**Local Government Agencies**

Numerous city and county departments of planning, economic development, or public works operate local grant, loan, and other types of financial-assistance programs. Many have considerable experience in program targeting and linking public to private resources. At the same time, many of these same agencies often are hamstrung by limited staff capacity--both in terms of numbers and expertise--and are not able to take on additional program responsibilities.

**State and Local Development Authorities**

These organizations are authorized with the express mission of maintaining or expanding the state or local economic base. Many are empowered to raise funds by issuing bonds. Development authority staff usually have considerable expertise in financial packaging and public-private endeavors. Authorities can be more bottom-line oriented than public agencies, however, and they may be less willing to work with marginally viable businesses needing larger subsidies or partial grants. In fact, the nature of the financing authority--which may mandate a minimum level of cost recovery--can preclude them from offering this type of help.

**Quasi-Public Business Development Corporations and Economic Development Corporations**

These entities are often certified by federal agencies or chartered by state governments to provide a more flexible mechanism to deliver financial assistance. Some states have used them to circumvent their constitutional limitations on providing financial help to private companies. Typically, development corporations lend money to firms not able to borrow what they need from conventional lenders. Often they augment private capital at favorable rates. Some development corporations make equity investments, rather than loans, offering money in exchange for partial ownership in the project.

Business development corporations raise money through sales of stock. In this way, they spread the risk among many investors that no single lender is willing to assume. Local development corporations operate in a similar fashion; they are accountable to local government but are administratively independent. In either situation, these public corporations, in theory, could expand their scope to include an UST component to help companies that are creditworthy enough, or positioned to offer a sufficient return on an equity investment.

### State Regulatory Agencies

State departments of environmental protection that are familiar with the targeted customers also can administer assistance programs. Generally, however, they do not have the expertise and organization to handle or monitor the financial transactions. Also, possible or perceived conflicts between the agency's mission of regulating, the goal of easing the burden of compliance, and the responsibility of managing a large fund may cause some uneasiness among agency officials.

Any UST assistance program will require a great deal of coordination between the regulatory agency, which is familiar with the potential problems and needs of tank owner/operators, and the economic development agency, which is familiar with planning and implementing public-finance programs. Private institutions, as discussed in the following section, also can play a significant role in providing capital, assessing creditworthiness of an applicant, or even administering the entire program with limited government oversight.

One option pursued by some states with an UST assistance program is to establish a special board or commission authorized to oversee the program. Such an organization could draw from the directors of the relevant government agencies as well as private-sector representatives. For example, the Iowa UST board, which is responsible for overseeing the state's UST loan-guarantee program (among other responsibilities), consists of the directors of the departments of environment, commerce, and treasury and representatives of the insurance and banking industries. It may not be practical to create a new entity solely to administer an UST financial-assistance program unless it is given other UST- or financial-assistance-related responsibilities.

Another alternative is to hire a private company to administer the program under the direction or supervision of a state agency. Iowa lawmakers authorized its UST board to hire a private company to manage the UST insurance and loan guarantee programs rather than hire additional state employees. Employing a private administrator allows for quicker start-up of the program since the state hires only one company with the needed staff and experience, rather than several individual employees. Such a company may provide expertise not easily available through state hiring channels and at state pay scales. A private administrator also may be viewed as independent of any one interest--not solely the environmental or the economic development agency--especially if supervised by an independent UST board or commission. Finally, because the assistance programs may be temporary, the state can easily cancel the contract once the program expires. A disadvantage of using a private administrator is that the state may lose some degree of control over the program.

Finally, states have an advantage if they already administer a compatible development-finance program, which could be used as a model or expanded to include UST assistance. Such background makes it easier to provide the assistance quickly, without long program development and startup time and can make the program easier to sell to the legislature, businesses, and financial institutions.

## E. Using Private Lending Institutions

Private institutions often are brought into the public-finance program to participate either directly or in a supportive capacity. Banks participating directly could take applications, evaluate creditworthiness, and make lending decisions. Their incentive would be the prospect of increased business. Sweeteners, such as free advertising (through community program promotions or brochures, for example,) could also encourage their involvement.

Institutions playing a supportive role in a public-finance program may undertake one or more of the following loan-related tasks:

- take applications;
- advise businesses referred by public agencies;

- do preliminary screening of applicants;
- perform loan underwriting (credit analysis, risk evaluation, and setting terms and conditions); and
- advise government agencies on the creditworthiness of an applicant.

Depending on the nature of the finance program, they may also help with loan packaging and even participate in the financing themselves. Governments can contract for bank services or can "swap" for them. Linked deposit programs are based on the latter arrangement; agencies deposit their own funds in designated banks and agree to take a lower rate of return in exchange for bank staff performing various loan analysis and servicing functions for the program.

In either role, involvement of financial institutions can be structured to relieve government from the need to staff up to administer a financing program. This is the principal advantage of this approach; bank involvement in a financing program can prove to be the difference between program use and disuse for staff-starved local governments, especially in small towns and rural areas. In addition, this type of private-sector participation can enhance the credibility of the program in the eyes of potential beneficiaries, who might be more comfortable in dealing with their local bank than a government agency.

However, private institutions that take a direct role--do the lending themselves--are hesitant to reach out to marginal prospects or may not be willing to participate if the program is overly complex or cumbersome. The banker's aversion to risk will permeate the program, even if safeguards (such as state guarantee of repayment) are built in to protect the institutions. Bankers are particularly skittish in the wake of the recent savings and loan crisis since regulators may scrutinize high-risk projects more closely, intensifying banker's risk aversion.

The government trades off some degree of program control when it turns over program operation to the private sector. For example, since the bank, not the government, decides who receives assistance, targeting of specific sectors may not be easy. To ensure that the desired groups are reached, government agencies will have to define eligible targets precisely and explicitly in law or regulations. Because of these factors, some states have undertaken a dual approach when involving private lenders in public-finance program. In one situation, the government could refer qualified prospects directly to the participating bank. In the case of financially weaker companies, states may rely on private institutions for processing the paperwork or even analyzing the company's creditworthiness, but offer the actual financing themselves.

When contemplating use of a private entity or even a quasi-public corporation for administering an UST assistance program, states must face the issue of liability. Banks or other private financial institutions may be reluctant to participate because as creditors they may incur unwanted liabilities, such as cleanup or third-party damages, especially in the event of foreclosure. They may demand a special release from liability requirements. Lender liability is a sensitive issue and is often misunderstood. In planning an UST assistance program, this issue should be resolved early, possibly by including private entities in initial discussions on program administration. In fact, if the state is contemplating using private institutions for any aspect of the program, it is best to consult with them early. Too often programs are created with expectations of private-sector involvement only to find private lenders unwilling to cooperate.

## F. Measuring Program Success

When elected officials or program staff speak of measuring a program's effectiveness or the relative success or failure in achieving its mission, they are faced with the inevitable question of how to measure success. Such performance assessment is a key part of the program's decision-making and management process. Measuring a program's level of success helps policy makers and administrators make informed decisions about needed program modifications or changes in the level and type of support.

These program operate in a political milieu and, therefore, measures of success involving public programs and resources should not be made strictly from a dollars-and-cents perspective. Rather, governing agencies must examine the overall impact on a community and be willing to incur costs and/or risks to realize potential business and community benefits. Depending on the specific program design, benefits that might be measured--in addition to whether the program is within budget limits--could include:

- number of businesses retained;
- number of jobs retained;
- amount of tax revenues maintained or added;
- amount of private investment attracted to publicly-assisted projects; or
- increase in the size or number of private loans made to target businesses.

Public officials must also bear in mind that the assumption of risk not only is acceptable, but is a vital element of public finance programs. Reaching the businesses underserved by conventional lenders (the small, high-risk, often rural concerns), requires the state to assume a greater level of risk than private lenders would accept. This is not to say that public program managers should disregard conventional underwriting standards; a firm's general creditworthiness and management capacity must be thoroughly assessed so that despite risks higher than private institutions would accept, losses can be controlled. At the same time, public leaders must recognize and accept the fact that implicit in the assumption of risk is the possibility of default. Thus, when defaults do occur the entire program should not be jeopardized. Losses should be planned for and considered acceptable costs.

Instead of relying on profits, the program's success should be defined and measured based on its goals and intended outcome--what was it intended to accomplish, for whom, how much will be accomplished and within what timeframe. But because these goals and expectations are largely established through a political process, inflated promises are often made in the guise of program goals to secure the necessary votes. Moreover, these goals may lack clarity and coherence and may even be--in practice--incompatible.

Nevertheless, an efficient program-measurement process is an important component for both politicians and administrators; it helps them to answer the following questions:

- how well is the program managed;
- is the program doing what it was established to do;
- are realistic program goals achieved and why; and
- what difference did the program make--in the targeted area, among designated participants, etc.

A variety of external factors will also impact a programs success. Unfortunately, no consensus exists on exactly what outside factors are appropriate to consider.

# 2. Public Finance Tools

The term *economic development* has been defined in various ways over the years, but basically it is the process by which individuals and organizations decide to, and then invest capital in projects in a given area. The results are retained, expanded, or new industrial, commercial, or service enterprises, and new or retained jobs. Across the country, federal agencies and state and local governments are becoming more involved in meeting the challenges posed by economic change and increasing environmental sensitivity.

During the last 30 years, federal, state, and local officials have devised many methods, techniques, and strategies to stimulate development activities. They have moved, especially in the last decade, beyond the mere spending of more money. Now, programs and incentives may be very different in terms of targeted clientele, size, and required outcomes. As a result, the level and terms of assistance often vary between states for similar types of efforts.

As public-sector leaders work to craft effective financial-assistance programs targeted to UST-related needs, they should study case examples and other analyses that might provide valuable lessons. They should steer clear of a "cookbook" approach, however, and recognize that the principal element of success is government responsiveness to the needs of both investors and business operators in the state and local economy. This may involve mixing and matching of various tools to address different needs.

All state and federal economic development tools fall into one of two broad categories: financial and nonfinancial assistance. The former, finance incentives, are the focus of this report. (The latter include training and technical assistance initiatives, such as management counseling and marketing advice.) This section describes 11 types of financing programs. For purposes of this discussion, they are grouped into two categories. Six types seem particularly relevant for adaptation as UST initiatives--grants, loans, loan guarantees, interest subsidies, development credit corporations, and tax abatements. The chart on the following page summarizes their key features. All six are analyzed in some detail to explore the relative advantages and disadvantages if incorporated into an UST assistance program. Examples of the programs in practice also are briefly described. The other five--bond programs, equity financing, tax credits and deductions, tax increment financing, and tax-free zones--have less general applicability, although they could prove quite suitable given the right circumstances.

## A. Grants

Grants provide direct financial help and carry no repayment obligation. They are the most direct form of assistance, and the most heavily subsidized. States offering grant programs expect the recipient to survive and prosper as a result of the cash infusion, and maintain or expand their employment rosters and tax liabilities. Because repayment is not required, this type of assistance can be costly and require states to commit considerable resources continually. Using grants for UST-type programs may be complicated by legal restraints in many states on giving direct grants to specific businesses for permanent capital improvements.

When funding private-sector initiatives, political leaders recognize the potential for abuse--or the appearance of abuse--particularly in determining need and recipients. They are sensitive to charges of favoritism in dealing with private companies. Therefore, grants usually are given to pay for related costs of economic development, such as training, infrastructure improvements, or site preparation. In this manner, they can be tools for supporting the development process and serve as catalysts in making other deals or projects actually happen.

## Key Factors to Consider in Formulating an UST Assistance Program

| Type of Assistance | Terms of Assistance | Purpose | Principal Financial Supporter | Effect on Targeting |
|---|---|---|---|---|
| **Grants** | Few, if any conditions placed on assistance. Some states may require match. | Improves access to capital and reduces cost of capital. | State taxpayers. | Allows greatest targeting flexibility and control. |
| **Loans** | Public money is loaned for specific purpose; repayment expected. May offer no or low interest terms. | Improves access to capital and/or reduces cost of capital. | State taxpayers. | Allows targeting flexibility, with careful program planning. |
| **Loan Guarantees** | Public pledge to cover private loans made to riskier businesses in the event of default. | Reduces lenders risk. | Banks. | Difficult, since government does not decide who receives loan that's guaranteed. Important to have explicit eligibility criteria. |
| **Interest Subsidies** | Lower interest rates, because of direct state subsidy or incentives to private institutions. | Reduces capital costs. | Banks | Does not help business on the credit margin. Required outcomes (e.g., businesses retained) can be stipulated. |
| **Business Development Corporations** | Private funds offered to businesses otherwise unable to obtain loans. | Increases access to capital. | Private-sector members or subscribers. | State has little or no control on targeting. |
| **Tax Abatements** | Reduced or eliminated taxes owed. | Improves business cash flow. | Local taxpayers. | Can be tied to specific industries, activities, or areas. |

## Key Factors to Consider in Formulating an UST Assistance Program

| Program Funding Needs/ Timing of Outlays | Administrative Burden | Potential to Use Private Financial Institutions | Other Comments |
|---|---|---|---|
| High per-project cost. Requires continuous funding. | Low administrative costs; can be easily incorporated into existing grant programs. | None. | Susceptible to abuse. Best suited for mix-and-match approaches. |
| One-time infusion. Programs can be made self-sustaining; easily expanded. | Can be costly and time consuming, since each loan must be carefully evaluated. | Not practical, although use as companion/subordinate loans can encourage private lender participation. | Often administered by state chartered agency or corporation. |
| Reserve fund required to cover default payouts as needed. Fund can begin small and increase as program expands. | Private lenders shoulder most of the administrative burden; borrowers absorb most costs. | Maximizes private sector involvement and flexibility. | Neediest firms often fail to qualify. Easy to expand program. |
| Continuous funding required to provide subsidies to banks. | Private lenders shoulder most of the administrative burden; borrowers absorb most costs. | Maximizes private involvement, increases business's ability to take on debt. | Subsidies can be provided for different amounts and in different forms (e.g., linked deposit program). Does not improve small business's access to capital. |
| No public funds required to capitalize; may be linked to other programs. | Administered entirely by private corporation with periodic oversight by state regulators. | Private program subject to state rules. | Can adopt more flexible guidelines than state agency. |
| Foregone tax revenues for a specified time period (commonly 5 or 10 years). | Minimal, once structured. Needs oversight if sliding scale pegged to business performance. | None. | Not cost-effective to government. Does not help companies needing capital up front. |

To ensure program effectiveness, states must administer grant programs themselves. In this way, states have direct control over how the funds are spent. This includes screening applications and monitoring projects. Both tasks could be done jointly by state economic development and environmental protection agencies. Administrative costs will include managing the fund, evaluating the applications, disbursing money, and overseeing grantees. These costs will vary depending on the number of applicants, the complexity of eligibility criteria, and the number of recipients. For recipients, the ease of participating in the program will depend on the length of the application process and the amount of documentation required.

UST grant programs would eliminate the difficulties that small and economically disadvantaged tank owners face in obtaining low-cost financing. The biggest problem for state officials contemplating an UST grant program would be how to define need and target program beneficiaries--obviously, every owner would like free money to do necessary upgrades. Program size would be largely determined by state ability and willingness to pay.

To stretch limited resources, states may decide to offer grants on a matching basis, requiring tank owners to cover some of the costs. Alternatively, they may limit the type of activity eligible for grant funding to those having the greatest potential benefit, such as leak detection equipment. When considering such variations, though, state leaders will have to decide how to identify and serve tank owners who are unable to meet even minimal matching requirements.

The advantages of a grant program are that the state (or the state in conjunction with local governments) would decide which owners and operators should be helped, without regard to creditworthiness judgments of private lenders. Grant programs allow states the greatest flexibility in targeting program resources. They are the easiest way to reach the most economically needy owners. The disadvantages are the high public cost per-project, and the fact that the funds are never recaptured. Far fewer owners and operators can be helped with grants than with other types of financial assistance.

There are several ways to measure grant program performance, many based on ancillary benefits to the community. The most common yardsticks are grant costs per job retained or added, businesses retained, and tax revenue (sales and property) generated per project assisted.

**Examples of Successful Grant Programs**

More than half the states offer some kind of economic development grant program. Many of these programs require companion private investment as a condition of receiving state grant funds. Missouri's Development Action Grants (MODAGs) are patterned after the successful federal Urban Development Action Grant (UDAG) program. MODAGs are awarded competitively to cities with less than 50,000 residents, which use the proceeds to make low-interest loans for construction or renovation of buildings, machinery and equipment, and for working capital. Indiana, Michigan, New York, New Jersey, and several other states offer similar programs. In addition, federal Community Development Block Grant (CDBG) money distributed by the Department of Housing and Urban Development (HUD) can be used in both large and small cities for a variety of economic development purposes as long as projects meet HUD's broad eligibility criteria, which include expanding economic opportunities and encouraging private investment. Virtually all CDBG recipients have used a portion of their grant allocations for economic development projects.

## B. Loans

Loans allow companies to borrow from states or the federal government either directly or through local economic development agencies, authorities, or corporations. Loans are extensions of credit that require businesses to repay the principal amount with a specified rate of interest by a predetermined date. Most states have established loan programs; state agencies either extend the loans directly, or authorize state-chartered corporations or organizations to implement the programs. State officials must address several process considerations when structuring a loan program:

- the nature of the decision-making process--who will make decisions, what form of analysis and review will be used, how documentation will be verified, and the length of time required to approve or disapprove a loan;

- application information requirements and how they may vary by type of project;

- variables that influence loan terms and conditions, such as creditworthiness, collateral requirements, loan size, interest rates, time period money will be loaned, penalties, disbursements, and others;

- how the loan is to be serviced--who will monitor the loan, accept payments, deal with delinquencies, and related tasks; and

- reporting requirements to enable the agency to monitor the business's progress in carrying out the funded project.

Most states require collateral before issuing a loan so that if the business defaults, the state does not lose its entire investment. Loans often are made at advantageous terms and below-market interest rates, although federal Small Business Administration (SBA) loan programs--which in practice meet capital needs of small business--can carry interest rates up to 2.5 points above the prime lending rate. Most programs require a review of a business's financial status, including the qualifications of management; market potential for the product; level of collateral to secure the debt; and projections of cash flow to pay the interest and loan amount.

Loan programs often are pivotal in launching new or small businesses or firms engaged in speculative undertakings such as new technology development; these companies usually lack access to affordable capital from conventional lending sources. If states are willing to take the risk, they can use a direct loan program to provide loans that commercial lenders would usually refuse to make; for example, such targets could include small or financially shaky owners or operators, or projects needing only a small amount of money. Many state programs offer low interest rates. Some forgive or defer loan repayments or interest charged if certain thresholds--often linked to job opportunities--are reached. Most state loan programs currently in place finance long-term fixed assets, such as machinery or buildings. Tanks and related capital improvements would make excellent candidates for loan assistance. Loan programs can be structured in a variety of ways.

**Revolving Loan Funds (RLFs)**

Several states provide development loans through RLFs. These are pools of funds that can be compiled from several sources, including federal and/or state funds and investments from private institutions. RLFs gain an advantage by design, which is flexible and simple. The basic concept is straightforward. A state, city, or designated development organization provides businesses with direct loans, companion loans, or other financial assistance. An UST-related program, for example, would need investments related to tank system modernization improvements. As the loans are repaid, the money is made available to other firms; in essence, it revolves for new uses. The advantage of an RLF is that allows continual recycling of the original pool of money. This process makes public-sector investments go further and provides the state or issuing agency with a dependable, ongoing source of funds.

**Subordinated Loans**

In some situations, loans from public agencies are made as subordinated or secondary loans. Essentially, they serve as companion loans to lending that the company obtains from a private lender. They improve business creditworthiness by reducing private lenders' risks in two ways. First, they lower the amount of capital that private financiers must invest in a single project. Second, subordinated loans give the private lender first claim on assets in the event of a default by the borrower.

Simply put, a secondary loan program would operate in this way. A station operator needing $100,000 for tank improvements may be able to borrow only $60,000 from his or her local bank; collateral requirements and other factors may make the bank hesitate to commit a greater amount to the project. A state program could fill this gap by lending the balance and taking what is known as a subordinated lending position. In the case of default, the bank would have first claim on the collateral, up to the balance on the $60,000 loan; anything left over could be used to redeem part of the state loan. If there is no default, both the state and the bank are repaid. By reducing the risk for the bank, the state has encouraged the investment needed to make the tank improvements without having to finance the entire project itself.

**Companion Loans**

Some state programs attempt to reduce borrowing costs to companies by combining publicly subsidized loans with conventional private-sector loans. The state program offers a portion of the loan at a below-market rate. The private financier provides the balance at the prevailing loan rate, or whatever rate the state and the lender agree upon. The combination of the two loans gives the company sufficient capital for the project; the combination of interest rates results in a blended rate which is less costly to the borrower for the entire amount than the prevailing rate. This blended rate can make an otherwise unaffordable deal economically viable. It also reduces the state share of participation.

Program administration costs of loan programs vary. A few states have reached agreements with private financial institutions to administer their programs, but others have had difficulty in finding a willing private-sector participant. States undertaking administration of their loan programs will have to make sure that they have staff with adequate financial-analysis expertise if they are to control the risk of default. This is an important consideration, because many of the applications they review will be from companies that have been rejected by commercial lenders as too risky. In addition to the cost of credit analysis, states will have to cover expenses related to loan servicing, receipt of repayments, and project monitoring.

Loan programs are used to maximize state resources. Repayments can be used as capital for future loans; interest payments can be earmarked to cover program administrative costs. Earmarking state loan funds as companion loans can invite private-sector participation and stretch state funds even further; a companion loan program may also offer an opportunity to piggyback state program administration needs with comparable activities that the private lender will perform.

Loan programs bring several other advantages. They could address tank owners' lack of access to long-term financing; because the state typically would control the decision-making process, the programs could address common problems that businesses face such as obtaining long-repayment periods, securing relatively small amounts of capital, and overcoming inadequate credit records. This situation increases the likelihood that targeted owners and operators will get the assistance they need. To ensure that only firms with real difficulties get state help, applicants could be required to show that they had been rejected by commercial lenders, or able to secure only a portion of the needed project financing.

Loan programs also carry some disadvantages. Administrative costs for a direct loan program can be high because of the need to conduct credit analyses. Typically, application processing costs can run from several hundred to $1,000 per application--whether or not it is approved. Little savings are to be expected by contracting this task out to a private firm. In addition, because state loan programs often serve as the last resort for participating companies--those unable to secure financing elsewhere--the loan program could face a number of loan defaults. This will drive up program costs.

Defining the criteria for measuring success will in large part determine if a loan program is successful. Too often state officials emphasize the number of loans repaid, effectively discouraging loan-processing staff from taking any chances on marginal projects. A more appropriate set of evaluation factors would also include: consideration of the number of companies kept in business and the number of jobs retained (compared to the amount of assistance), the percentage of private capital, and the amount of tax revenue generated. In essence, public officials should look at the total economic benefit to a community stemming from loan program activity.

**Examples of Successful Loan Programs**

Nearly all states have authorized one or more direct loan programs to address a variety of business financing needs. Most programs are carried out by state government-sanctioned development authorities. Loan programs are of special interest to small- and medium-sized companies because maximum loan amounts are typically $1 million or less. The source of loan funds may be state tax revenues or the proceeds from general obligation bonds floated to capitalize the program. Direct loan programs are often used when a state wishes to make a one-time budget appropriation to help small firms or a certain business sector. Usually, a state program will provide less than 100 percent of the project costs, requiring a company to either inject some of its own cash or secure a portion of the project financing from conventional lenders. The interest rate, loan maturity, and maximum loan amount differ among states, and sometimes even within states for different businesses.

Some 35 states operate loan programs specifically aimed at financing equipment and machinery purchases. Illinois's Small Business Development Program offers long-term, fixed rate, low-interest loans of up to $750,000 for fixed-asset financing, particularly for buildings and equipment. State loans are limited to 25 percent of the total project cost and must attract private financing. New York's Targeted Investment Program (TIP) helps industrial and commercial firms in areas of proven business risk--especially in blighted communities and areas of high unemployment. The Massachusetts Business Development Corporation (MBDC) provides loans for small or medium-sized businesses that cannot obtain all financial requirements from conventional sources. Financing for 100 percent of project costs is available. To stretch MBDC resources, program loans often are joined with federal Small Business Administration (SBA) financing resources offered through SBA's "development company" program, also known as the SBA Section 504 program. (In the 504 program, an SBA-certified development company guarantees 40 percent of the project costs, and a private or non-federal lender, such as MBDC, covers most or all of the balance.) In these situations, MBDC finances the capital needs of a business that are not covered by SBA assistance.

## C. Loan Guarantees

Loan guarantees were devised to minimize the risks that often make private financial institutions hesitant to lend to small businesses. They are the pledge of the state or federal government to cover most or all of the outstanding balance of a loan made by a private lending institution in the event the borrower defaults. Loan guarantees lower the risk of lending, thereby increasing the availability of capital and often reducing the cost of borrowing. A loan guarantee program would make commercial lenders more likely to offer loans to small operators and those whose fiscal health would ordinarily make lending to them too dicey. Many banks, in fact, are eager to make guaranteed loans because the guarantee lowers what bank regulators refer to as "risk ratios;" the guarantee strengthens the performance of a bank's loan portfolio in the eyes of regulators because the guaranteed portion of the loan can not be subject to default or become--in banking parlance--"nonperforming." Loan guarantees provide banks with a sought-after backstop.

In essence, loan guarantee programs serve as a risk "cushion" that encourages private lenders to make loans to businesses that otherwise would not qualify for them. Because the loan is backed by the government guarantee, banks are more easily persuaded to lower interest rates or collateral requirements. States find loan guarantees more attractive than direct loans because they are less expensive: most guarantees are never exercised.

Government agencies must establish a reserve fund that they can tap to repay defaulted loans. Generally, this reserve should be about 10 to 20 percent of the outstanding loan balance during the early stages of program life, depending on the expected level of risk built into the program design and the portion of the loan the agency pledges to redeem (most programs guarantee between 75 and 95 percent of the loan amount). Once a track record is established, the amount of the reserve can be adjusted. For example, SBA, which has operated loan guarantee programs for decades, is proposing to add only $91 million in fiscal 1991 to support more than $3.8 billion in new loan guarantees--a reserve of less than 3 percent.

Guaranteed loans are generally used by states that prefer the private sector to provide funding or share in the risk of extending credit. As with direct loans, guarantee programs are generally limited to small and mid-sized companies. The fact that private lenders or the business owners themselves must bear some of the risk--namely, part of the loan (ranging from 5 percent to 25 percent) that is not guaranteed--serves to restrict the size of individual loans. Most loan guarantee programs are limited to firms that demonstrate (through rejected loan applications) an inability to obtain private credit.

Administrative procedures are the same for virtually all state guarantee programs: a private financial institution evaluates the creditworthiness of the applicant and provides the loan funds and the state agency or authority guarantees repayment of a substantial portion of the loan. By reducing or eliminating the lender's risk of loss due to default, guarantee programs make capital more available or affordable to business owners.

Loan guarantees do not require as much staff expertise as direct loans because most or all of the loan processing, risk assessment, and credit analysis is performed by the private lender. In implementing a guarantee program, state leaders will want to define eligibility standards, an application review process, and procedures to follow in the event a business defaults on its loan. Agency staff will want to estimate possible financial liabilities and determine likely losses that might arise from the program. State officials will also want to oversee the terms that banks are extending on the loans that the state is guaranteeing to make sure that program requirements are met and program targets are reached.

Loan guarantee mechanisms can stretch available state resources even further than direct loans and can serve as an effective vehicle for involving the private sector. At the same time, greater direct participation by private lenders generally reduces the ability of state and local agencies to target program resources directly. Private institutions will seek to reduce risk and liability and may not be sensitive to other program goals.

Guarantee programs have several advantages. For example, the presence of a loan guarantee may prompt commercial lenders to extend the loan repayment terms, which makes the capital more affordable. It also allows some flexibility as the state can reduce the percentage of the loan it is willing to guarantee, thereby cutting its level of risk and potential for loss. For example, a state can limit the guarantee level to 75 percent or less, reducing its potential liability without changing any component of the program. Agencies can even offer variable guarantees based on a businesses creditworthiness. In Iowa's UST assistance program, for example, banks are allowed to charge a slightly higher rate of interest if the state only guarantees 50 percent of the loan. The bank then has an incentive to assume a slightly higher level of risk but is likely to do so only if the business receiving the loan is financially sound.

By reducing its guarantee level the state may also reduce its program costs, since banks assuming 25 percent or more of the risk will probably be more conservative in evaluating a company's financial information than if they had to take only 5 percent--or none--of the loan risk. This reduces the likelihood that the program reserve will have to be tapped to redeem a defaulted loan. At the same time, more conservative bank scrutiny means that fewer and fewer marginal or needy projects will be approved for funding. As private lenders are asked to bear more risk, they are less likely to lend to firms with marginal fiscal qualifications. This increases the possibility that the loan guarantee program will simply become a substitute for private lending that would have occurred anyway. Thus, tank owners and operators most in need of a loan guarantee may end up being the ones least likely to get it.

As they do with loan programs, states frequently will increase guarantee program authority periodically; this action requires a larger reserve fund, although it may be a smaller fraction than originally established if the program demonstrates a successful history of paybacks. If default rates are low, loan-guarantee programs will cost little over the long term. However, with each default, the cost of a guarantee program increases.

In contemplating program performance, state officials should consider the same types of factors as those for measuring loan program performance--the number of companies helped to continue operating, the number of jobs saved, and the amount of tax revenue maintained or added to state and local coffers. Clearly, the level of defaults will be the one criterion that program critics and advocates alike will examine first.

**Examples of Successful Loan Guarantee Programs**

Nearly 20 states and the federal government provide loan guarantee programs to support lending to private businesses. California's Small Business Loan Guarantee program guarantees up to 90 percent of the total amount financed for short- and long-term loans for a variety of needs, up to $350,000. Louisiana Guaranteed Loan Program guarantees up to 75 percent of commercial loans to small and medium-sized businesses, up to $500,000. The federal SBA offers two major loan guarantee programs--known as the Section 7(a) and the Section 504 Certified Development Company (CDC) programs--and several small ones targeted to specific constituencies such as veterans and the economically disadvantaged. The largest is the Section 7(a) program which will make more than $3.9 billion in loan guarantees available in fiscal 1990 to small companies on the risk margin. Loans involving Section 7(a) guarantees are made at prevailing market rates; loans for machinery and equipment can be guaranteed for up to 15 years. The Section 504 program is more structurally complex. Essentially, it guarantees up to 40 percent of project costs incurred for buildings, equipment, machinery, and land. Up to $750,000 in proceeds can be guaranteed, for terms as long as 20 years. In both programs, the effect of the guarantee is to reduce lender's risk which encourage them to make loans they otherwise would avoid.

## D. Interest Subsidies

The interest subsidy is an attractive alternative to direct loans that has emerged at the state level in recent years. Basically, this incentive encourages private lenders to make loans to businesses at terms more favorable than the borrower would otherwise expect, or where the borrower would otherwise not be able to secure the loan at all. Interest subsidies--sometimes known as interest "buydowns"--make loans more affordable to business borrowers by reducing their carrying charges. Frequently, rates are brought down several points below the prevailing market rate. In exchange, the government sponsor usually stipulates eligible uses or outcomes (such as type or location of investment, or number of jobs created) for the proceeds of the subsidized loan.

Interest subsidies can take several forms:

- the state can pay banks a fixed number of interest-rate points, regardless of the terms of the loan;
- the state can cover any interest payments in excess of a specified interest rate; or
- the state can pay a fixed portion of the total interest payments.

In the first case, the state will know in advance exactly what its costs will be; it is the borrower who will have to grapple with fluctuations in interest rates. If the state agrees to pay three interest points on any loan taken for an UST-related project, the actual rate that the tank owner pays will depend on the market rate at the time the loan is secured. For example, if the market rate is 10 percent, the owner will pay 7 percent; if on a subsequent project the rate has risen to 12 percent, the owner will have to pay 9 percent. This version is the most politically palatable because it allows the state to firmly fix its share of costs. However, it offers the least help to needy companies in times of high interest rates; even with the subsidy, many cannot afford to borrow.

In the second case, the state assumes the risk of changing interest rates; the rate paid by the tank owner remains unchanged, but the level of subsidy provided by the state would fluctuate as interest rates changed. In other words, if the state agrees to pay any interest costs in excess of 7 percent, the state will pay three points on a project financed at 10 percent interest, but five points if interest rates rise to 12 percent. This option provides businesses with the best buffer against unstable interest rates, and increases the chance that they will be able to pass the scrutiny of private lenders. Under this option, the state runs the greatest risk of significantly higher costs if market rates rise significantly. (Of course, the state could see its commitment reduced if rates fall.) This type of interest subsidy requires sophisticated state staff expertise to forecast state costs.

The third type of interest subsidy is essentially a hybrid of the first two. Generally, the state agrees to pay a reasonable portion of all interest costs, say 25 percent. In this case, both the state and the private business agree to absorb the fallout from fluctuations in the market interest rate.

**Linked Deposit Programs**

Occasionally, states use an indirect form of interest subsidy such as the linked deposit. In this instance, a state government deposits its funds in designated financial institutions and agrees to accept lower-than-prevailing interest rates. In exchange, the institution agrees to make loans (usually, up to the amount of the state deposits) to specific classes of borrowers at correspondingly reduced rates. States have used linked deposits to channel capital to distressed areas and to boost projects considered important for public purposes that private lending institutions otherwise might not consider.

As with loan guarantee programs, administrative responsibility for all types of interest subsidy programs resides chiefly with the private lenders making the loans. Although the state would not need to do its own credit analysis, it would have to track the interest subsidy fund to make sure that it has enough money to meet its share of the necessary subsidy payments. State administrative tasks would include processing the bank's applications for subsidies, arranging payments to participating banks, and monitoring projects to make sure that the subsidy funds were spent on projects that met program objectives.

The chief advantage of this program is its ease of administration. Unlike loan or loan guarantee programs, the state can rely totally on private lenders to conduct credit analyses, assess risks, and make the loans. The state can articulate its intentions on program targets in the agreement signed with participating lending institutions. The state simply sends payment for its share of the interest carrying costs.

On the other hand, interest subsidies do not improve a borrower's creditworthiness nor increase a tank owner's access to capital. Loans are approved or disapproved based on a business's credit standing; the interest subsidy simply reduces the cost to the borrower. In effect the subsidy makes borrowing more attractive, even in larger amounts. If the interest subsidy is not great enough, tank owners and operators have no incentive to participate. An interest subsidy of only a point will save the borrower $1,000 or less on the typical UST loan during the course of a year--not enough to encourage the desired investment.

Interest subsidy programs are best measured in terms of the amount of increased investment activity they stimulate. For example, because businesses could obtain larger loans without paying more in interest, they might invest in better protected tanks. Another way of evaluating their effectiveness is determining how many loans were made affordable to borrowers because of reduced interest costs.

**Examples of Successful Interest Subsidy Programs**

The pioneering linked deposit program is Ohio's, initiated by the state treasurer in 1983. Known as the Withrow program, it invests up to 12 percent of the state's investment portfolio in one- and two-year certificates of deposit (CDs) at Ohio banks at terms up to 3 percent below prevailing market rates. In return, participating financial institutions holding these CDs lend amounts equivalent to their value at 3 percent below the prevailing rate. Iowa's Community Economic Betterment Fund offers a subsidy to reduce the interest rate on loans that promote economic development--essentially, the program buys-down the rate several interest points. The Maryland Small Business Development Financing Authority provides interest subsidies of up to 4 percent on loans to finance buildings, equipment, and similar needs.

## E. Business Development Corporations

An important source of investment capital, especially for small companies, is the publicly chartered private development bank, usually called business development corporations (BDCs) or development credit corporations. These organizations are privately operated but are authorized by state legislation and operate under state rules. Several states have chartered them as an alternative to direct loan and loan guarantee programs, especially those with constitutional restrictions on using state funds to help private business.

BDCs generate most of their capital from private sources, such as banks, insurance companies, and similar institutions, that purchase shares of stock, provide advantageous loans, or extend lines of credit to the corporation. Some of the most recently authorized BDCs have used state-granted tax credits to attract individual and business investments in the corporations. Often, participation in a BDC allows the financial institution to participate in less risky companion or shared loans as part of a financing package assembled by the BDC for a small business. In some cases, companies participate for public relations purposes or to demonstrate social responsibility.

BDCs make credit available to businesses that cannot secure it from conventional lenders and tend to be more flexible in their financing guidelines than state agencies. Interest rates are generally above prime, meaning that the BDC program does little if anything to reduce the cost of capital; this minimizes its usefulness for firms with cash-flow difficulties. Eligibility for assistance and the terms and conditions of the loans vary among the different state BDCs. Some of the more restrictive corporations will consider only loan requests referred by member or investor organizations willing to participate in the lending for the project. Most BDC activity is directed to small companies that use the funding for construction and working capital.

The size of any BDC loan pool usually is limited by the size of the reserve fund maintained by the corporation and the willingness of member financial institutions to make companion loans or otherwise participate in project financing. BDCs rarely make individual loans greater than $500,000. Often, a conventional lender will refer a marginal borrower to a BDC; the lender may then share the financing with the BDC, taking a senior loan position (which means that it has first claim on collateral assets in the event of a default).

The primary advantage of BDCs is that they can provide money for businesses that would otherwise be considered too risky for conventional loans. BDCs are not subject to the same federal or state loan performance regulations as traditional financing institutions and therefore may assume greater risks. BDCs also make an attractive partner for conventional lenders to team up with to share financing of a project; the BDC is often willing to assume a subordinate position. For example, a private financier could provide 60 percent of the financing for a $100,000 project, with the BDC supplying the remaining $40,000. Since the private lender would have first claim on assets in the event of a default, this loan-sharing lessens the private lender's risks, encouraging them to look more favorably at UST small business loans. It also could lessen collateral requirements for prospective small business borrowers who may only have to secure $60,000 of a $100,000 loan. Finally, because BDCs typically handle mostly high-risk loans, they have more experience in working with such projects and can process them more efficiently than most conventional lending institutions.

The state assumes no risk in BDCs, although most monitor them to ensure compliance with state rules. Some development officials have observed that BDCs tend to become conservative lenders, even though they are chartered as risk-taking institutions, because of their need to attract participating banks or stockholders.

**Examples of Successful Business Development Corporations**

More than 30 states have chartered BDCs, including large and small, and urban and rural states--Connecticut, Pennsylvania, Rhode Island, Illinois, and Montana, among others. The Iowa Business Development Credit Corporation, a consortium of financial and lending entities, provides loans of up to $500,000 to businesses for fixed-asset financing. The Indiana Corporation for Innovation Development, which focuses on emerging products and technology, raised $10 million in initial capital by offering private investors a 30 percent credit against state taxes owed. The Louisiana Small Business Equity Corporation acts as a financing intermediary, providing loans of up to $2 million to local development corporations and certified development companies, which then re-lend the proceeds to small business.

## F. Tax Abatements

Tax abatements are reductions in, or forgiveness from, tax liabilities for a period of time. They are most commonly given for property taxes, but they also are granted for sales, inventory, and equipment taxes. Tax abatements stimulate new construction or building improvements in areas where property taxes or other conditions discourage additional private investment.

States must usually authorize local governments to offer tax abatement programs. Most state legislation designates only certain areas, such as economically distressed communities or deteriorating neighborhoods, as eligible for abatements. Abatements can be tied to specific industries or activities, company size, or sales volume. Some states abate taxes on various types of machinery and equipment, such as pollution-control equipment.

Tax incentives such as abatements reduce a business or property owner's tax payment, which can leave them with more cash to invest in site improvements or expansions. The cash-flow savings associated with tax incentives also may help the business owner or developer obtain financing from private lenders. When assessing a project, lenders examine projected revenues and operating expenses. The larger the excess of revenues over expenses, the greater the company's ability to support debt.

Tax abatements are among the oldest economic development incentives. They can take several forms: freezing the assessed value of land or buildings at some point in time (often, at a pre-development date); reducing the tax rate for a certain period of time (commonly five or ten years); and exempting certain types of property from taxes altogether. Some abatement programs feature sliding scales--full abatements are granted initially, when business cash needs are the greatest; the level of abatement is reduced (and the amount of tax owed increases) over time until the firm pays its normal levy. Other programs link tax payments to business income or profitability. Frequently, the percentage of abatement is tied to company performance in areas such as increasing job opportunities or investment within the state.

Tax abatement programs, like most tax programs, are easy to implement once decisions on program incentives and design have been made. Tax programs are usually administered by state or local revenue or tax departments, or the treasurer's office. Virtually every state operates some sort of tax abatement program.

Typically, tax abatement incentives are best suited for physical, "bricks-and-mortar" development projects than job-generating activities. If used alone, tax abatements would only be useful to UST businesses where cash-flow is a problem and would not help owners and operators who need money up front to make needed improvements. Many small businesses need greater financial help than reduced tax liabilities.

Tax abatement programs must be carefully designed to target intended beneficiaries without offering unnecessary subsidies. This is important, because tax abatement programs have numerous detractors. From the government's standpoint, tax abatements mean a reduced stream of tax revenues. From a public policy standpoint, considerable evidence exists that tax incentives are the least cost-effective form of subsidy that governments can offer; one tax dollar a city forgoes generally results in less than a dollar in actual benefit to a firm. (For example, while the business's local taxes decrease, the amount the company can deduct from federal taxes also decreases, thereby increasing the business's federal tax liability.) Many economic development officials and state and local governments complain about tax abatements, disputing their effectiveness and stressing their economic inefficiencies; yet nearly all states offer them. The key advantage of tax abatements is that they give local governments a workable incentive that helps influence private investment decisions.

Defining standards to measure the level of success of tax abatement programs in a way which reflects their actual impact on business operations can be difficult. Few revenue baselines exist against which to measure changes in revenue attributable to the abatements. One important effect that can be documented is the extent to which necessary UST improvements are made by recipients of the abatements.

**Examples of Successful Tax Abatement Programs**

Tax abatement programs have been implemented for decades in hundreds of cities across the nation. Ohio's program, authorized by its Impacted Cities Act, allows abatements for large and small-scale industrial, commercial, and multi-family residential projects. Missouri's program allows local development corporations to improve property. In addition, tax abatements have been included as incentives by nearly all of the 32 states implementing "enterprise zone" economic development programs since 1980. Connecticut's enterprise zone program permits a 7-year abatement on taxes attributable to property improvements. Kentucky's program allows local governments added flexibility in granting tax abatements and other incentives for businesses within designated zones.

## G. Other Applicable Financing Tools

The remaining five programs will have less general applicability, although they could prove valuable in specific circumstances. The first of these, bond financing, is less prominent since passage of the 1986 tax act, which cut the number of eligible activities and added other restrictions. Creative equity financing is a "comer" in economic development circles, poised to assume a larger role in financing strategies as more agencies gain expertise in promoting this type of program. The other programs examined are various tax incentives, which offer many of the same opportunities and suffer from the same problems as tax abatements.

**Bond Financing Programs**

Bond financing programs help economic development projects in every state. They take several forms.

*General Obligation (GO) Bonds*

GO bonds are issued for a many types of activities--traditional public projects such as schools, construction of infrastructure facilities such as roads and sewers, and others activities. They are also floated to meet various financing needs. For example, states can issue GO bonds to provide funding for economic development loan funds like those described earlier in this section. General obligation bonds are backed by the "full faith and credit" of the issuing jurisdiction. In the event of a default, the government that sold them would ultimately would be responsible for paying bondholders for the bonds and accumulated interest.

Because of the government backing, GO bonds can be issued easily with few restrictions on their use, provided the sponsoring jurisdiction has a good credit rating. However, these bonds require voter approval. All types of programs and projects use GO bond proceeds.

*Industrial development bonds (IDBs)*

When speaking of bond financing for economic development purposes, officials and practitioners usually are referring to IDBs. The bonds are authorized or issued by cities, public agencies, or development authorities. They provide financing to help a private company acquire buildings, equipment, and the like for an industrial project. Because they are issued on behalf of private enterprises, they are commonly called private purpose bonds. In legal parlance, they are "revenue bonds"; essentially, this means that the company is responsible for repaying the debt. If the company defaults, the bondholders, not the local taxpayers, absorb the loss.

IDBs are used for projects such as mass-transit facilities, privately- operated waste-disposal facilities, and manufacturing projects. The interest paid on IDBs is not subject to federal or state taxation, so they can be offered at lower-than-market rates. In essence, IDBs are a form of interest subsidy with the government agreeing to forego some tax revenue to lower the interest rate required by investors.

*Pooled Bond Issuances*

Some jurisdictions use pooled or umbrella bond issuances to offer financing to smaller projects. These bonds are issued by states on behalf of a number of companies that individually would be too small to qualify for a normal bond program. Several individual bond issues of $1 million or less are put together in one package. Under most umbrella or pooled IDB programs, eligible loans are bundled as a package and issued as part of one bond offering (typically a minimum of $8 to $10 million). Pooling reduces the risk to the bond purchasers and enables small businesses to raise needed funds. Currently, umbrella bond programs are operated in nearly half the states.

**Equity Financing**

Equity financing programs try to make capital available to needy businesses rather than lower its cost. They promote development by investing funds in capital-poor but otherwise competitive companies. In practice, states make equity investments much like private investors: through its administering agency, the state takes an ownership interest in a company in exchange for funds. The company is expected to repay the loan as its income or profit increase. Equity is a riskier channel of investment for the state. If there are no profits or the business folds, the state makes nothing or even loses its money. On the other hand, if the company does well, the state can reap a substantial return.

Equity programs have proven most popular in high-growth industries offering the potential for substantial return on investment, which is how this type of investment is justified politically. Since UST projects rarely fit this economic profile, the practical use of equity financing programs for them is limited. They can fill a niche in some cases, however. Equity programs are well suited to narrow targeting; for example, to rural areas where station operations are pivotal to the health of the area economy.

**Tax Credits and Deductions**

Tax credits and deductions are provided against business income tax liability to encourage specific economic behavior. A tax credit usually takes the form of a direct reduction in the amount of taxes owed by a company. Tax credits are offsets to taxes due, and accordingly increase a company's cash-on-hand by lowering the amount that has to be paid in taxes. In contrast, a tax deduction reduces a firm's taxable income, meaning that the actual benefit to the business depends on its tax rate. Because a deduction is subtracted from income before taxes, while a tax credit is subtracted from the taxes due, a deduction provides less of an incentive than a tax credit of equal amount, but also costs less to the government in terms of foregone revenue.

Like tax abatements, credits and deductions will not help the small tank owners and operators who need money to make improvements. They can, however, improve cash flow so that the company can has a better chance of qualifying for needed private financing to undertake the improvements. Tax credits and deductions also are easily targeted to specific activities. They can be structured, for example, to encourage tank upgrading; states could adopt tax incentives that give credits for certain portions of cleanup costs or deductions for leak-detection systems.

**Tax Increment Financing**

Tax increment financing (TIF) uses the anticipated growth in property tax revenues generated by a development project to finance public-sector investment for it. TIF does not lower the amount of tax revenues collected, nor does it impose special assessments on the project area. For example, a successful station now pays $12,000 in taxes. The city or state determines that if the station were abandoned, it would only pay $5,000 in annual taxes. Under a TIF system, the city will use the $7,000 difference to finance long-term site improvements that would otherwise not be financially viable.

Government agencies often use this method to encourage growth in large, multibusiness areas that are underdeveloped or abandoned. Tax increment financing for UST-related efforts would be most appropriate in encouraging reuse and modernization of unused sites. This type of financing can be costly to administer although some economies can be achieved if several sites are targeted.

**Tax-Free Zones**

Tax-free zones are targeted geographical areas, such as state enterprise zones, in which special activities are allowed or incentives are offered that are not available outside of the zones. These include investment tax credits and other tax benefits such as exemptions from incomes and property taxation. Some states give preference to zone businesses when considering applicants for loan and grant programs.

In other cases, state and local governments designate certain areas to receive special public support. For example, states use public funds to upgrade and prepare sites for development projects, adding utility hookups, upgraded infrastructure, parking, and other physical improvements. Economic development agencies also may lower site costs by selling publicly owned land and buildings to developers at less than market value, or donating it outright.

Developing a new state tax-free zone program targeted to UST owners and operators will be politically difficult if not impossible. However, it may be practical to add UST-related investments to approved lists of eligible program activities, or increase tax benefits for UST projects to encourage investment activity. In any event, state and local officials should explore whether station owners and operators doing business within an existing enterprise zone could benefit from their location within a designated zone.

## H. Combining Incentives for UST Initiatives

Each of the financing incentives described above can be used by itself as the basis for structuring an UST program to promote tank modernization and upgrading. As indicated by the matrix on pages 16 and 17, however, different types of incentives address different financing needs. Often, a business will have diverse financial needs and require more than one type of incentive to secure necessary funds for improvements at rates and terms for which it can both qualify and afford.

In many instances, state officials will want to encourage a mixing and matching of available financial incentive programs to address a full range of needs. Sometimes, they might urge tank owners and operators to tap into existing economic development finance programs; in other cases, state leaders will want to press for the creation of new initiatives. Most of the 11 incentives described above are suitable for this type of combination approach.

- Grants can be combined with loan guarantees and interest subsidies to fill financing gaps that private lenders will not address.
- Low- or no-interest public loans can be offered as subordinate or companion loans to private market-rate loans to result in an affordable financing rate for the total funding needed for a project.
- The combined financial impact of interest subsidies and tax abatements or credits can improve a company's overall cash-flow position to allow it to take on a larger amount of debt, and thus make a greater investment in tank improvements.
- Complementary state programs can be linked to federal financing programs, expanding the impact and usefulness of both.

There are as many possible mix-and-match combinations as there are financing needs to be met. For example, an interest subsidy program will reduce the cost of capital, but will not minimize a lender's concern about the project's level of risk if that also is a problem. Therefore, a loan guarantee may also be needed to reduce the risk sufficiently to attract private capital. In other cases, a bank may have concerns about the amount of collateral that is offered, or the ability of station owner to meet loan payments. In these situations, the state may offer a grant to accompany the private loan.

Sometimes, UST financing needs are best met by splitting a loan into two parts--one private, and one state-subsidized--to make it affordable to the station owner. If a station owner needs $100,000 to upgrade but prevailing private interest rates put payments beyond reach, the state could step in with a low-interest loan program for half of the financing, so that the combined payments to the private lender and the state would be affordable. In this case, if the station owner was offered a $50,000 state loan at 4 percent, he or she would only need to borrow $50,000 at prevailing small business rates, approximately 14 percent. When the two interest rates are blended together, the station owner in effect has received the $100,000 loan at 9 percent interest. This would reduce monthly payments on a ten-year loan by $270, or $32,400 over the life of the loan.

In considering various types of program incentives, state and local officials are likely to find that no one type of incentive best fits the needs of a most station owners and operators. Therefore, several complementary financing options might need to packaged together. This could mean a small grant program to help the neediest businesses make necessary UST improvements; a loan guarantee program to attract private capital to projects on the risk margin; and an interest subsidy program aimed at operators who are cash-poor but otherwise bankable. Both Iowa and Ohio, for example, are considering adding a grant program to target businesses not reached through the states' other UST financial assistance efforts.

State programs also can be combined with federal programs, notably SBA loan guarantees or HUD Community Development Block Grant (CDBG) funds. State programs can be designed so they can serve as matching funds for federal assistance, or address financing gaps left by federal programs. For example, SBA's Section 504 program requires project financing to be arranged as follows:

| **Funding Source** | **Amount** |
|---|---|
| Private-sector/non-federal financier | 50% |
| SBA 504-backed security | 40% |
| Local injection/owner contribution | 10% |

For the typical $100,000 tank improvement project, the SBA 504 program could provide $40,000 in assistance. SBA defines *private sector* as any non-federal source. Therefore, a state loan program could make a $50,000 loan to cover the required private participation in the project. The 10 percent local injection must take the form of cash or property, according to SBA regulations. However, states can further support the project by giving a grant to the company to meet the local injection requirement.

## 3. Conclusion

Since World War II, state and federal officials have created many programs to spark general economic activity and investment as well as address specific development problems that have emerged. Many of these initiatives failed to achieve their goals, however, particularly those that were overly ambitious or vaguely defined. Unsuccessful programs tend to be those that:

- provide insufficient funding or resources to achieve program goals;
- experience changes in eligibility criteria from year to year, complicating planning efforts by potential recipients;
- require excessive interagency coordination at either state or federal levels;
- designate a lead agency that has only a marginal stake in the program;
- use agency personnel that already have other full-time program responsibilities; or
- require a substantial amount of complex, long-range planning and program management without providing enough support to program administrators that must bear those responsibilities.

There are no strict guidelines on how to pursue economic development. The experiences of other states and communities may be instructive, but each locale must identify its own gaps and move to fill them in its own way. However, several factors improve a program's odds of survival. First, programs should be clearly focused and feature objectives; they should be framed by a succinctly worded, easily understood mission.

Second, successful capital programs should provide a creative way to finance needed improvements, tailoring incentives and terms of assistance to the needs and capacity of the targeted business. To the extent possible, private-sector participation should be encouraged. Most publicly sponsored programs simply cannot succeed without involvement and cooperation from banks, other financial institutions, and the business sector. Programs also must be easy to plan and administer. Local banks, government agencies, and potential recipients must understand how to participate.

Finally, flexibility is essential. The development-finance process--especially in new arenas such as USTs--is characterized by shifting arrangements, unexpected opportunities, a changing cast of players, and changing relationships between them. Program managers must be able to respond quickly and effectively to the changing economic development climate; programs mired in rigid rules are usually doomed to failure.

Government agencies with experience in administering assistance programs and those familiar with the needs of the targeted beneficiaries can be an important resource to lawmakers in crafting new programs. Agencies can help identify key issues and needs, define opportunities and goals, and devise strategies and programs to address all of these.

In the final analysis, the success of a public finance program is defined by its initial goals. If the intention is to preserve small, rural businesses, then one measure of success will be if enough of these businesses continue to operate. However, success has many routes. This paper outlines some of the tools to select from and factors to consider that will help achieve success.

# Appendix A
# Examples of State UST Assistance Programs

This appendix examines the underground storage tank assistance programs of two states: Iowa and Ohio. These programs include many of the options that states can use to help underground storage tank owner/operators.

## Iowa's Loan Guarantee Program

Concerns about the adverse impact of new federal tank requirements on the state's farming communities spurred Iowa legislators to consider ways to assist small tank owner/operators. The state estimated that as many as one-third of Iowa's gasoline stations would close as a result of new federal requirements. Losses would be concentrated in rural communities, potentially devastating the small farms already stressed by the farm depression of the 1980s. Lawmakers also sought to protect groundwater, an important natural resource given Iowa's dependence on farming and large number of shallow wells.

In 1989, the legislature overwhelmingly voted for House File 447, which is designed to address both the rural economic and environmental issues raised by new federal tank rules. The new law contains, among other elements, an UST loan-guarantee program. The law encourages banks to loan money to small, high-risk businesses for the purpose of improving or replacing tank systems (including pipes and monitoring equipment) to meet new federal standards. As incentive to the banks, the state guarantees to repay up to 90 percent of the loan amount if the small business defaults. Banks also are protected for liabilities associated with the loan by receiving financial responsibility coverage as part of the state insurance program.

Lawmakers considered several forms of assistance, including direct loans. They settled on a loan-guarantee program primarily because it allows the state to stretch funds further than direct loan or grant programs. Another advantage of loan-guarantee programs is the involvement of the private sector which minimizes the need for increased state bureaucracy.

The goal of the program is to help small tank owner/operators in rural areas, especially those that are the sole source for a community's gasoline and heating fuel. The law defines specific requirements as to what business may be eligible for assistance. A business must meet the following criteria: own no more than two locations and no more than twelve tanks; possess a net worth no greater than $400,000 and show a previous rejection by at least two financial institutions. In applying for a loan, the applicant must complete a financial statement, which is verified by past income tax reports.

The law specifically targets small businesses that are the sole source of fuel for a community. Local governments are permitted to offer a property tax credit to small businesses that own or operate underground tanks in order to protect public drinking water supplies, preserve business and industry within a community, maintain convenient access to gas stations, or other public purposes. The business may use the credit to improve existing tanks or install new tanks only.

A second allowance allows the state to give sole-source businesses priority for loan-guarantee assistance if needed. Thus, the state will give priority to sole-source businesses in paying off defaulted loans. This issue will arise only if the funds for a given year are not sufficient to cover all defaults, in which case payments may be delayed on other defaulted loans. Banks thus have added assurance that sole-source loans, even if slightly riskier than others, will be repaid first.

The vast scope of the new law (which also creates a fund for cleanup and insurance), made it impossible to settle on one state agency to administer the program. The insurance commission supported the bill actively, but the program also required the participation of the Department of Natural Resources, which was responsible for implementing the new federal technical requirements, the state treasury, and the Iowa Finance Authority, a quasi-public/private agency that issues state-backed bonds. Legislators also were wary of increasing the size of the state bureaucracy when the program will end in ten years when all tank owner/operators must meet federal standards or close. To accommodate all responsible agency interests, the legislature created a five-member UST Board to supervise the program. Board members include the director of the Department of Natural Resources, the state treasurer, the commissioner of insurance, and two private representatives with experience in financial markets and/or insurance.

The board's primary task is supervising the program; it hired a private consultant, Williams and Company, to run it day to day. For the legislature, the advantages of a private contractor conducting the daily administration include the company's expertise in insurance, banking, and environmental regulation and the fact that a private contract could be canceled when the program expires. The legislature's goal of privatizing the insurance function of the program at some point is advanced by building necessary experience and capacity within the private sector. Legislators believed that a supervisory board with diverse interests and a private administrator would provide the program with efficient management without permanently increasing the size of state government.

Local banks are responsible for issuing the loans after approval by the board. Banks have some flexibility in determining the terms and conditions of the loan within state guidelines, depending on the creditworthiness of the business. For example, if the bank is willing to accept a 50 percent rather than a 90 percent guarantee, the bank can charge a slightly higher interest rate. In this transaction, the bank assumes a greater risk (it may lose half of the loan amount), but benefits from the higher interest revenue. No limits are placed on loan amounts, which can be used to pay the costs of improving or replacing tanks, pipes, and monitoring equipment as well as the owner's "copayment" portion of cleanup (the owner's 25 percent share of cleanup costs, or a minimum of $5,000).

The board expects that 7 to 12 percent of the businesses will default based on the federal Small Business Administration's default rate for small businesses. Defaults are paid from a loan loss reserve account which is part of the trust fund established by the legislature. The trust fund is supported largely by an environmental protection charge (EPC) assessed against the volume of petroleum presumed to be lost into the environment through releases and evaporation. (The state has a constitutional provision that any direct, per-gallon gasoline tax must be used for road-related expenditures.) The EPC is to generate $12 million per year. To provide initial capital for the trust fund, the state will issue revenue bonds which will be repaid by the EPC.

After one year with the program, the state expects to seek adjustments in the law. Eligibility criteria were changed in April 1990 to widen the number of businesses that could benefit from the program. Another problem that has surfaced is that small, rural banks, which are the primary source of loans for the small gas stations, lack experience with loan guarantee programs and may be reluctant to participate. To correct this, a proposal to consider adding direct loans, when no bank is available for a loan guarantee, will likely be presented to the board.

The challenge for the board is to ensure that the assistance is channelled to businesses with critical needs without exceeding estimated default rates. Without the assistance program, one-third of the gasoline stations were projected to close. With the loan-guarantee program, the state hopes to keep the number of business closings to less than 15 percent.

## Ohio's Linked Deposit Program

In 1989, Ohio lawmakers debated approaches to structuring the state's underground storage tank program to meet federal requirements. They realized that small businesses would be financially strapped to comply with the federal insurance requirements alone. Thus, these businesses would have no funds remaining to improve their tank systems.

Under pressure from the oil industry to help small businesses in meeting federal technical requirements, the Ohio legislature included a financial-assistance package in its comprehensive underground storage tank program. Based on the recommendation of the state treasurer, lawmakers specifically selected a linked deposit type of interest subsidy to help UST owner/operators.

Under the linked deposit program (LDP), tank owner/operators apply to a local bank for a loan to cover replacement or upgrading costs. The bank may either approve or disapprove the loan based on the applicant's creditworthiness. If approved, the bank may then apply to the state UST board (formally titled the Petroleum Underground Storage Tank Release Compensation Board) for a linked deposit. After the board approves a bank's application, it directs the state treasurer to deposit a low-interest Certificate of Deposit (CD) with that bank. In exchange for paying lower interest to the state, the bank agrees to reduce the interest charged on the loan to the tank owner/operator.

Legislators, the state treasurer, and industry supported the LDP in large part because the state had used such programs successfully for many targeted businesses (for example, dairy farmers). The LDP offered several advantages over other forms of assistance for UST activities. The same funds to be used for the LDP must also cover cleanup and insurance, so the state wanted a safe, low-cost way of helping small businesses. Because the money is invested in CDs, the state has no risk of losing its investment. The primary cost to the state is forgone interest revenues that it would have received on a regular CD. However, over the long term, the loss in interest income should be replaced by tax revenue from more profitable businesses and retained employment. For past LDPs, the state treasurer has estimated that $3 is returned to the state in increased tax revenues and reduced unemployment and assistance costs for every dollar invested.

The LDP lowers the cost of borrowing for small businesses, making it more cost-effective to borrow or encouraging them to borrow more money, for example to undertake more thorough tank improvements. However, an LDP does not help marginal businesses that would not otherwise be eligible for a loan. To change for this situation, the legislature specified that banks give priority to the economic needs of the area in which owners' tanks are located. In practice, this may mean that, all other things being equal, the board may be more willing to participate in a linked deposit on a loan to a business in an economically distressed area. This emphasis is likely to be an issue in years that money for the LDP is limited.

The statute specified that only loans to businesses that own six tanks or less are eligible for the LDP. This threshold was determined from information provided by industry and the Ohio Fire Marshal's office (lead state agency for USTs) that small tank owner/operators in Ohio typically owned one or two stations with two to four tanks per station. Legislators also considered restrictions on eligibility based on income. They were concerned that even large companies (for example an airline) might only own six tanks and would thus be eligible for assistance. At the time the legislation was going through, however, figures on the appropriate income threshold were difficult to identify. As a result, lawmakers left it to the board to make the appropriate cutoff.

Other details also were deliberately omitted from the statute, such as the procedures for banks to apply for a linked deposit. Instead, the board was given responsibility for issuing rules governing administration of the program.

Although the state treasurer had experience with administering LDPs, the UST program was assigned to the board to manage. Unlike past LDPs that were funded with state money, this one uses funds paid by the petroleum industry through fees on underground tanks. The industry was more comfortable knowing that their money would be handled by an independent entity whose primary interest was to manage the fund.

The board consists of nine members appointed by the governor and confirmed by the state Senate. Only five can belong to the same political party. Members must include representatives of petroleum refiners, petroleum marketers, retail petroleum dealers, and local government. Two must represent businesses that own petroleum tanks, but are not primarily engaged in selling petroleum; two must be professional engineers with experience in geology or environmental engineering and not associated with petroleum industry; and one must have experience in casualty and fire or pollution liability insurance. The state treasurer and directors of the Ohio Commerce Department and Ohio Environmental Protection Agency are nonvoting members of the board.

The state treasurer is the custodian for the fund, but all other aspects of its management are the responsibility of the board. The board also has the authority to raise additional revenue, if needed, by issuing revenue bonds. Revenue bonds combine neatly with the LDP, since as the CDs mature, they can be used to retire the bond debt. The board also has authority to raise the tank fee after one year. The state treasurer estimates that the initial tank fee will generate approximately $20 to $24 million each year. Funds must cover cleanup costs, insurance claims, the LDP, and administrative costs of the board. Despite urgings by some state officials, no minimum amount of funds were set aside for the LDP; the board must determine the appropriate allocation based on funds remaining after cleanup and insurance claims are paid.

In the future, the state may consider adding a grant program to the UST financial-assistance package to aid some of the marginally profitable businesses that are not helped by the LDP. The advantage of a grant program over the LDP is that the state can have total control and flexibility in targeting businesses. For example, they could focus assistance solely on stations with older tanks and located in economically distressed areas.

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